Internal Revenue Service

memorandum

CC:TL-N-3025-89
Br4:CRGilbert

date: MAR 3 1 1989

to: District Counsel, Oklahoma City CC:OKL

from: Assistant Chief Counsel CC:TL
(Tax Litigation)

subject: Request for tax litigation advice
[redacted]

This replies to your January 25, 1989 tax litigation advice request. The issue is whether the tax benefit rule under I.R.C. § 58(h) (repealed by the Tax Reform Act of 1986) requires that when computing the net income limitation for tax preference intangible drilling costs under I.R.C. § 57(a)(11) (now I.R.C. § 57(a)(2)), excess percentage depletion under I.R.C. § 57(a)(8) (now I.R.C. § 57(a)(1)) not be deducted from the amount of oil and gas income under I.R.C. § 57(a)(11)(C). Because this issue is one of first impression and impacts on developing Service policy regarding the proper role of I.R.C. § 58(h), we sought the views of the Income Tax and Accounting Division (CC:IT&A) in formulating our response. We agree with you that since the petitioners received a regular tax benefit from both their percentage depletion and their intangible drilling costs (IDCs), the tax benefit rule is inapplicable; however, we believe that since Rev. Rul. 84-124, 1984-2 C.B. 14 presents a substantial litigating hazard and is not readily distinguishable, the instant issue should be settled on any reasonable basis, if possible, and conceded otherwise.

ISSUE

Whether the tax benefit rule under I.R.C. § 58(h) requires that excess percentage depletion not be deducted in determining the net income limitation used in computing tax preference IDCs.

FACTS

Involved are docketed and nondocketed years which are part of one examination cycle, covering taxable years [redacted] through [redacted]. All other issues are resolved for the docketed years. The I.R.C. § 58(h) issue arose when the parties calculated tax preference IDCs for [redacted], a nondocketed year. In computing the net income limitation for tax preference IDCs under I.R.C. § 57(a)(11)(C), the petitioners did not reduce their net income from oil and gas by the amount of their excess percentage depletion under I.R.C. § 58(a)(8). As a result, the petitioners

09020

claimed no tax preference IDCs for [redacted] even thought they were able to utilize in full their IDCs and percentage depletion for regular tax purposes.

DISCUSSION

Since excess percentage depletion impacts the computation of tax preference IDCs, each additional dollar of excess percentage depletion automatically results in an additional dollar of tax preference IDCs. The petitioners therefore assert that the tax benefit rule of I.R.C. § 58(h) requires modification of the computation of tax preference IDCs so as to remedy this "double counting" of tax preference items.

In support, the petitioners rely heavily on Rev. Rul. 84-124, 1984-2 C.B. 14, which concerns the proper computation of alternative minimum tax in light of the interplay between the I.R.C. § 1202 capital gains deduction, a tax preference under the tax law prior to 1987, and the adjusted itemized deductions preference, a tax preference for years prior to 1983. The interplay between the two tax preferences resulted in each additional dollar of the capital gains tax preference automatically adding more than a dollar to the amount of alternative minimum taxable income. Congress had not foreseen this result, and Rev. Rul. 84-124 applies I.R.C. § 58(h) as a remedy.

Even thought the revenue ruling concerns alternative minimum tax, rather then minimum tax as here, and different tax preferences, there is no question that it presents a substantial litigating hazard. Both the instant issue and the revenue ruling concern a situation where a taxpayer has fully utilized the involved tax preferences for regular tax purposes. It is arguable that the revenue ruling is distinguishable on the basis that I.R.C. § 58(h) requires a taxpayer's tax preferences be adjusted if such preferences do not result in a reduction of tax for any taxable years, and that both the petitioners' percentage depletion and IDCs reduced their regular tax liability. Nonetheless, we believe that the outstanding revenue ruling is not sufficiently distinguishable so as to allow for the successful litigation of the instant issue. Unfortunately, it may be better for the Service to concede rather than risk a near certain loss and the establishment of adverse precedent at this time.

Enclosed for your convenience is a copy of the March 13, 1989 memorandum issued by CC:IT&A in response to our request for their views. Please note that this is a privileged document and may not be disclosed to the taxpayers or made part of the file in this case. Despite the minimization of the effect of Rev. Rul.

84-124 in their memorandum, CC:IT&A shares our concern in litigation and concurs in our recommended course of action.

In connection with this case and with other minimum tax/alternate minimum tax cases where we have been asked to provide tax litigation advice, we have formally requested that CC:IT&A expeditiously consider revocation (or modification) of Rev. Rul. 84-124 so as to strengthen our litigating posture in the future. Our recommended course of action here is without prejudice to future litigation, which, depending on the extent of the litigation, may involve considerably larger amounts of minimum tax.

If you have any questions or need further guidance, please contact Craig R. Gilbert at 566-3305.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By: _____
HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

Attachment:
Memo. dated March 13, 1989